Moscow Financial Weekly

For the week ending January 23, 2004
Treasury Attache's office, U.S. Embassy Moscow

Highlights

- Budget Focus Section (see end of document)
- Nonresidents to regain access to GKO/OFZ market; some capital controls may remain
- Russian banks to form rudimentary credit bureau, but without U.S. private firms
- DIA structure and leadership revealed

Key Economic Indicators

Indicators	Level	chg 1 week	chg since Jan. 1	chg 12 months
RUB/USD (MICEX) UTS (changes in %)	RUB 28.5694	1.08	2.54	9.55
RUB/EUR (changes in %)	RUB 36.3462	0.40	1.30	-5.93
Monetary Base* (changes in %)	RUB 1385.3 bln	0.98	-0.49	51.35
CPI	NA	NA	NA	NA
International Reserves* (billions)	USD 79.1	USD 0.2	USD 1.3	31.2
RTS Index (changes in %)	624.87	5.31	10.18	82.24
Urals Crude (changes in %)*	USD 29.71	3.85	8.27	2.27
JPMorgan EMBI+ RUS spread (changes in bp)	240	3	-17	-194
CBR Time Deposits Two-week term (changes in bp)	Auction Cancelled[1]	NA	NA	

*For one week prior

Economic Developments

Two months after the State Duma has approved the budget, the Ministry of Economic Development and Trade (MEDT) has increased its official **world oil prices** forecast. The

[1] The CBR received bids ranging from 1.5-7 %, and cancelled the auction because it was dissatisfied with them all.

budget price is USD 22/bbl and the Ministry considers it to be rather conservative - the new forecast is USD 25.5/bbl for Urals and USD 26.75 for Brent. Taking into the account the direct link between the price of oil and GDP growth, the Ministry also announced an increase in its forecast for 2004 GDP growth from 5.2% to 5.5% p.a.

At the same time the MEDT Minister German Gref has announced that preliminary **growth of the economy in 2003** totaled not less than 6.9%; production grew by 7% for the year. Most of the growth is attributed to the high world natural resource prices.

Goskomstat announced that **industrial production** grew by 6.3% y-o-y in December and by 7% y-o-y for the year, compared to 3.8% in 2002.

The joint-stock company "**Russian Railways**" plans to reveal its capital investment plans in the near future. The company needs to attract additional resources this year as part of its restructuring process, mainly in the form of bank loans. Currently, the company doesn't have specific plans, but is holding consultations with major Russian and foreign banks. The total value of the investment program is expected to be USD 7 billion, out of which USD 4 billion will be from internal company resources and the rest is planned to be raised externally.

Banking sector

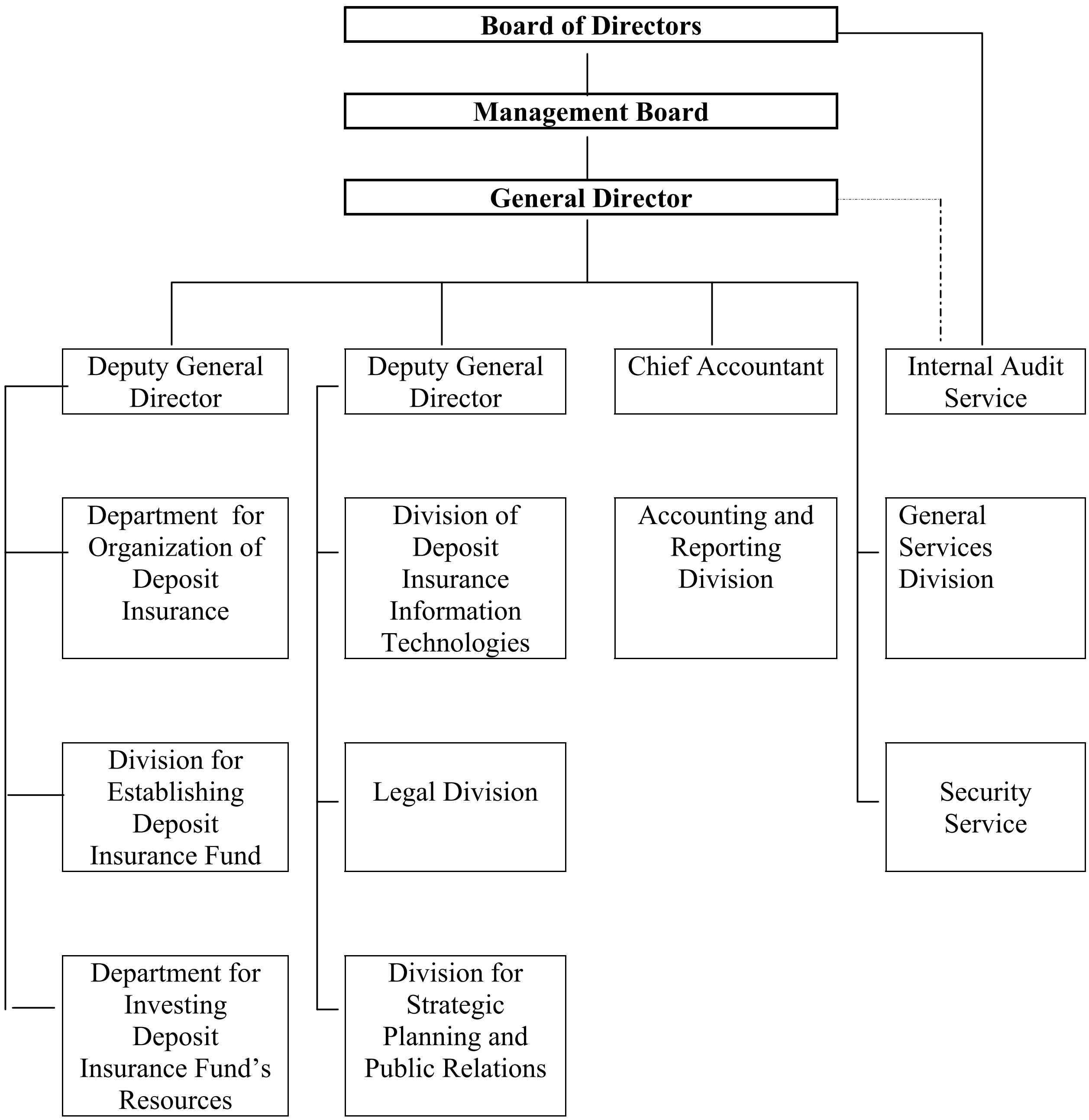
In mid-2004, as soon as the new currency regulation law comes into effect, nonresidents will regain access to the **domestic debt market**, Sergey Shvetsov, CBR Department of Open Market Operations told a meeting of professional participants of the debt market. He said that the CBR is preparing regulations on foreign investors' presence in the GKO/OFZ market. Shvetsov also reminded the traders that, depending on the balance of payments situation, the CBR might impose certain limitations for nonresidents, in particular to require them to freeze 20% of the investment in a non-interest-bearing account at the CBR for one year.

CBR Deputy Chairman Konstantin Korishchenko, Shvetsov's supervisor, said that that the CBR may sell RUB 60 billion in **government bonds** from its own portfolio in 2004.

Probusinessbank announced that it had received a convertible subordinated loan in the amount USD14 million for 6 years with an option to extend for 3 additional years from the European Bank for Reconstruction and Development (EBRD). Probusinessbank is going to use these funds to purchase controlling stakes in regional banks. It already owns a controlling stake in VUZ-Bank (Yekaterinburg) and has a rep office in Tula, and, reportedly, plans to acquire controlling stakes in 5-7 regional banks over the next two years, focusing in particular on such cities as St. Petersburg, Krasnodar, Rostov-on-Don and Nizhny Novgorod.

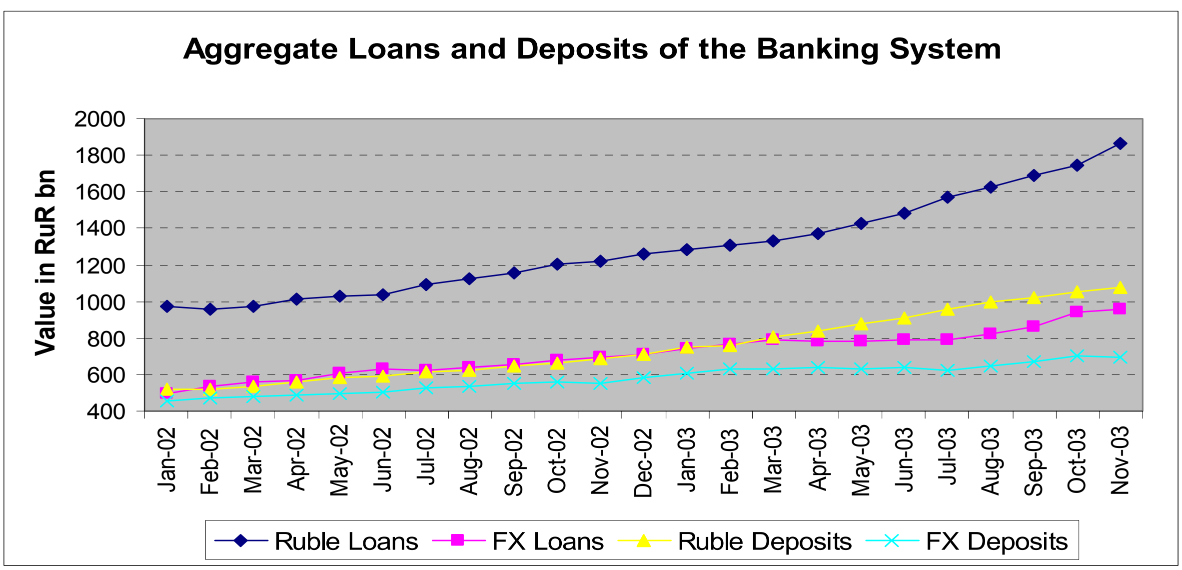
On January 22 the Board of Directors of the **Deposit Insurance Agency** (DIA) had its first, organizational meeting. The Board elected Aleksey Ulyukaev, First Deputy Finance minister as DIA Chairman and Aleksandr Tourbanov, formerly General Director of the Agency for Restructuring Credit Organizations (ARCO), as DIA General Director (both of them had been nominated to these positions by the GOR). The Board also approved DIA's organizational structure. Reportedly, DIA will have between 100 and 140 employees, mostly coming from

ARCO. Tourbanov is expected to officially request to be relieved of his position as ARCO General Director within the next few days and the joint meeting of ARCO and DIA Boards of Directors, scheduled to take place on February 3, will have to approve this request. Marina Chekurova will most likely replace Tourbanov in the position of ARCO General Director. DIA will become operational once it registers its official address and opens an account at the CBR, which is expected to happen on the first week of February.



Renaissance Capital reported, with a reference to the *Interfax* new agency, that the Association of Russian Banks (ARB) would establish a **credit bureau** without a foreign partner, following the breakdown of talks with two of the world's leading credit agencies, *Experian* and *Trans Union*. This development is not altogether surprising, as differences of opinion had emerged between the parties: in particular, with regard to the potential profitability of the arrangement. The ARB took the view that establishing a functioning and effective system was the priority, and that turning the credit bureau into a profitable business would come later. However, for the Western agencies involved, the profitability of participating in any credit bureau system is clearly of critical importance. It appears that the Western agencies were also surprised at the difficulties that would be involved in finding and sharing information on loans granted prior to the past couple of years. The emergence of an effective credit bureau system in Russia is, we believe, an essential ingredient for the further development of the Russian banking system, and the differences that have emerged between the participants highlight the complexity of creating an effective and profitable system. While a large number of banks have signed up to a protocol of intent with the ARB, this remains a long way from the actual sharing of information about customers and their credit histories. Essential to the success of any such scheme is mutual trust, this remains the largest issue facing the establishment of a successful credit bureau system.

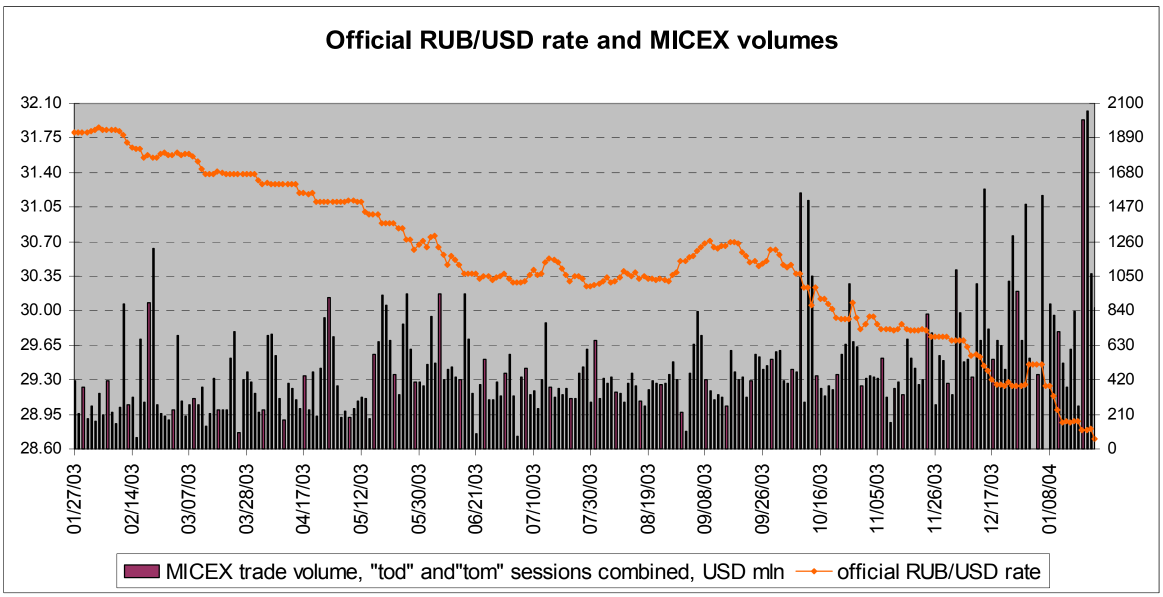
The CBR revoked the license of **Imperial Bank**, effective January 21, 2004, "for failure to observe Federal banking laws and Bank of Russia regulations", as well as inability to satisfy creditors' claims and make mandatory (tax) payments. Back in 1995 Imperial was the third largest by capital in the country, but its problems began even before the 1998 crisis. It started sinking after such influential shareholders at Gazprom and Lukoil abandoned it, went into receivership and at last lost its license.



Financial markets

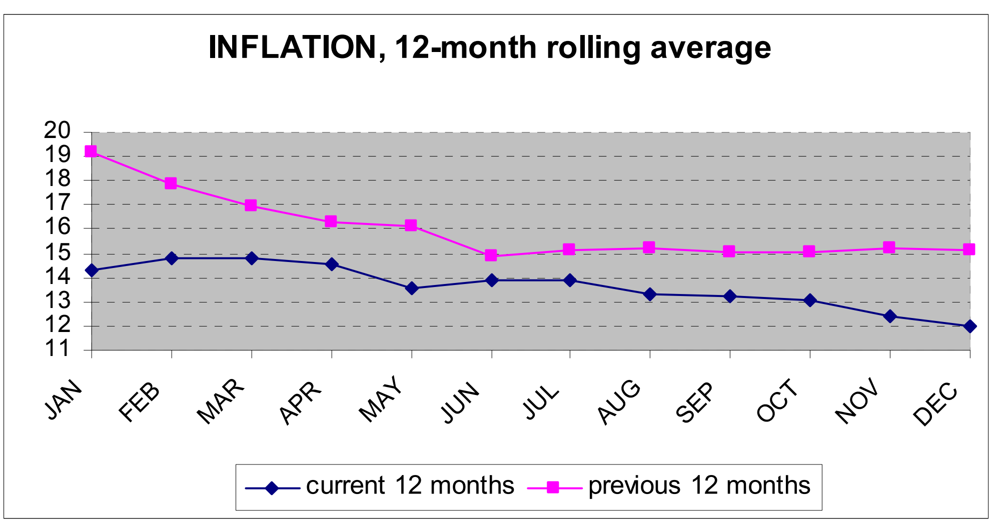
Forex Market

At the beginning of the week, the CBR moved its bid on the currency markets down to RUB 28.7850/USD, 10 kopeks below the level of the previous MICEX trading sessions for dollars with next day delivery. Monday trading was slow, on very moderate volumes, but by Tuesday the supply of dollars surged, bringing the aggregate MICEX volume for the day to a record high of USD 1,997.2 million. The next day the CBR went on buying dollars at the same rate, RUB 28.7850/USD, and Tuesday's record was broken, with the aggregate volume exceeding USD 2057 million. Having bought at least USD 2 billion over these two days, beginning Thursday the CBR abandoned the market, and the dollar resumed weakening against the ruble on decreasing volumes. Between Wednesday and Friday afternoons, the dollar with next day delivery lost another quarter of a ruble.



Prices

No new data available this week.

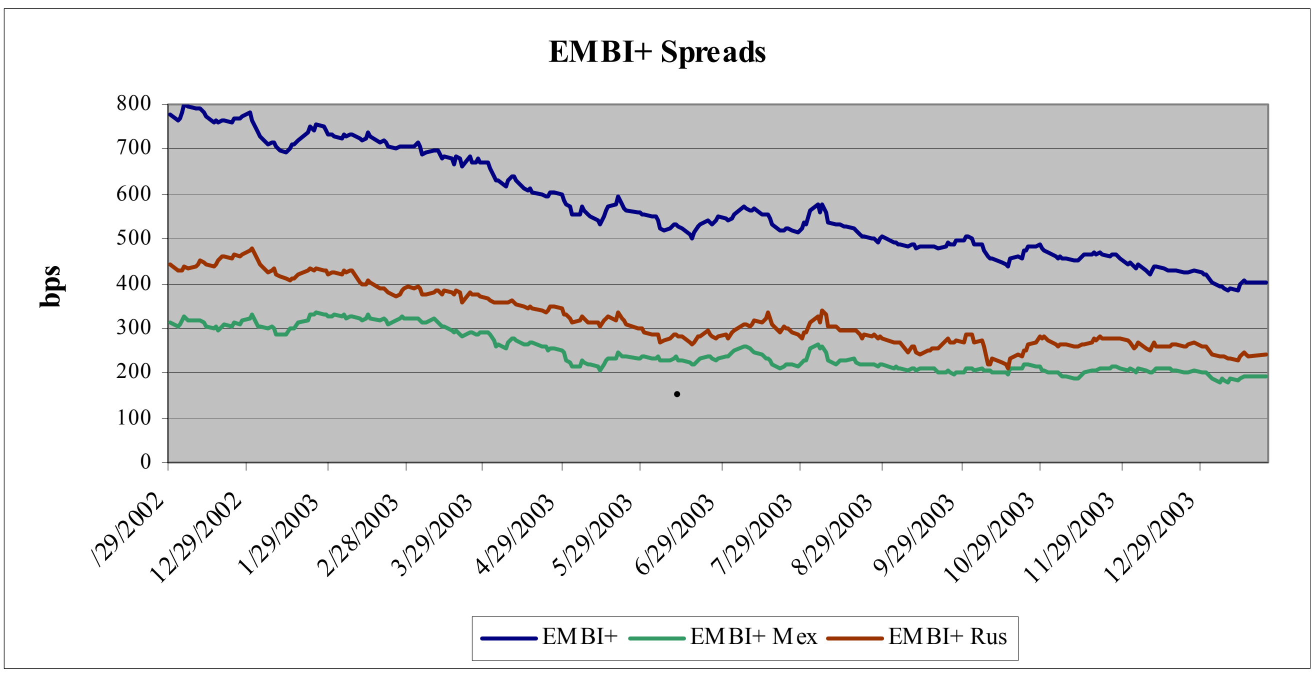


Eurobonds

Moody's announced the possibility of decreasing the corporate credit rating of YUKOS in the near future as a result of the increased financial risks of the company. This announcement follows the S&P downgrade in December. Back then the S&P lowered the rating with a negative forecast which implies the possibility of a further downgrade in the future.

In the absence of influential news, the Russian Eurobonds market was stable last week. Trade volumes were lower than average and prices of most issues finished the week slightly down.

COMPONENT	COMPONENT SPREAD & DATE				SOVEREIGN RATING		
JPMorgan's	01/23/04	01/16/03	12/22/03	01/22/03	S&P	Moody's	Fitch
EMBI Russia	240	237	258	434	BB	Baa3	BB+
EMBI+	401	404	424	749	N/A	N/A	N/A
EMBI Brazil	426	436	478	1392	B+	B2	B+
EMBI Mexico	195	191	203	329	BBB-	Baa2	BBB-
EMBI Turkey	286	308	315	730	B+	B1	B



Bonds/Bills

The secondary OFZ/GKO market experienced some downward price corrections in the beginning of the week, as participants waited for the MinFin auctions. On Wednesday, the Finance Ministry placed two OFZ issues (see table below). On the same day, the Ministry made OFZ coupon payments and redeemed OFZ issue number 28001, for a total of RUB 11.8 billion. This money supported demand on the auctions.

Issue Type	Issue Number	Nominal RUB Auctioned	Final Maturity	Average Yield
OFZ	46002	6.71 billion	2012	7.97%
OFZ	46001	6.42 billion	2008	7.82%

Overnight rates

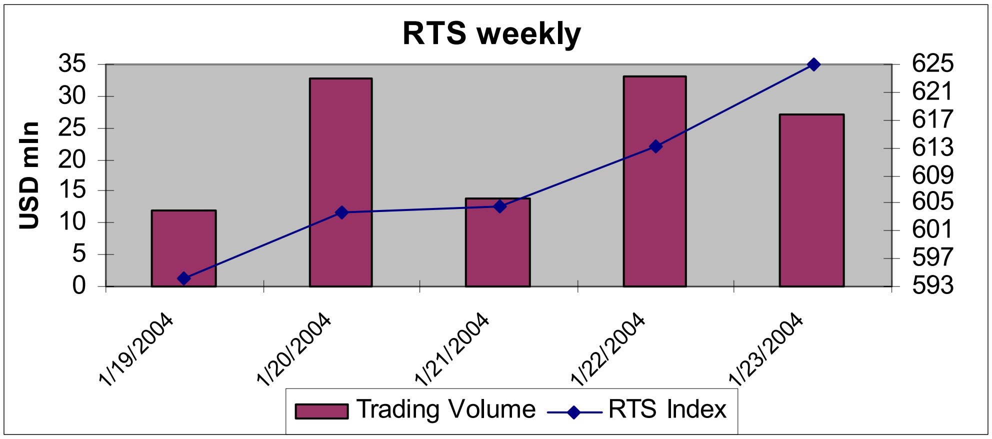
Ruble liquidity remained high last week. Balances on banks' correspondent accounts at the CBR dropped to as low RUB 194.7 billion during the week, but were up to RUB 251.6 billion by Friday (from RUB 216.4 billion on the previous Friday). The situation is explained by the period of the VAT tax payments. Overnight ruble loan rates increased slightly compared to the week before, fluctuating in the range of 1.0-1.3% p.a.

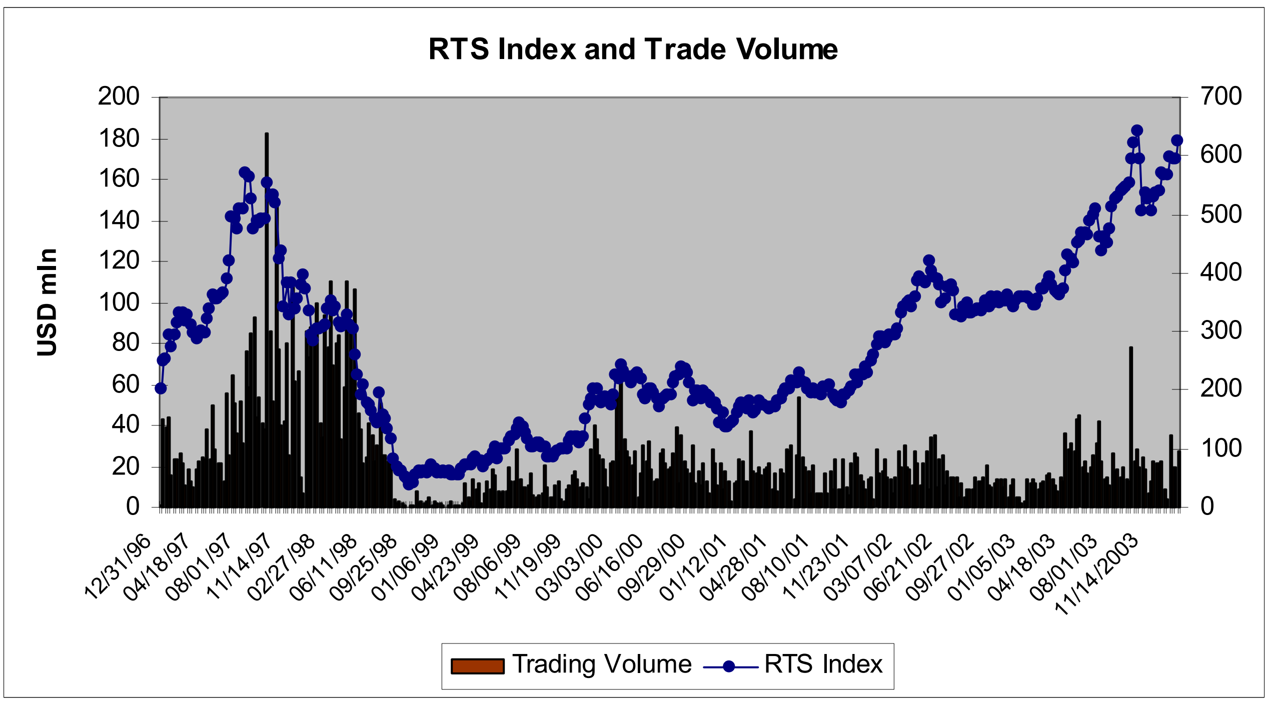
Stock Market

MEDT Minister Gref announced last week that there are no serious impediments for the liberalization of Gazprom shares trading (i.e., lifting the so-called "ring fence") and that the process is planned to be completed in the second half of 2004. If this liberalization is brought into effect, Gazprom shares could be traded on any trading floor licensed by the FCSM, restrictions on depositories which register domestic Gazprom shareholders would be banned, and foreigners would be allowed to fill the 20% quota in the shareholder structure. All these measures would positively affect the capitalization of the company and work toward the integration of the domestic and external markets for Gazprom shares.

The extraordinary shareholders' meeting of the steel group "Mechel" held on January 23 approved the additional issuance of 30% shares of the enterprise. These are the shares which are going to be traded in the form of ADRs. This decision had been expected, as the company has been actively restructuring in order to enter the capital market. The group combines Chelyabinsk Metallurgical plans and several more nickel and metallurgical concerns.

The Russian stock market continuously rose throughout the week on increased trade volumes. The RTS index pierced through the psychologically important level of 600 on Tuesday, and by Friday stopped only 19 points away from the record high closing level of 643.3 points seen on October 20 of last year. Most of the shares showed positive dynamics last week. YUKOS shares were an exception to the upward trend, which is not surprising given the regular drumbeat of negative news about the company. The RTS index was up by 5.31% for the week and by 10.18% since the beginning of the year.

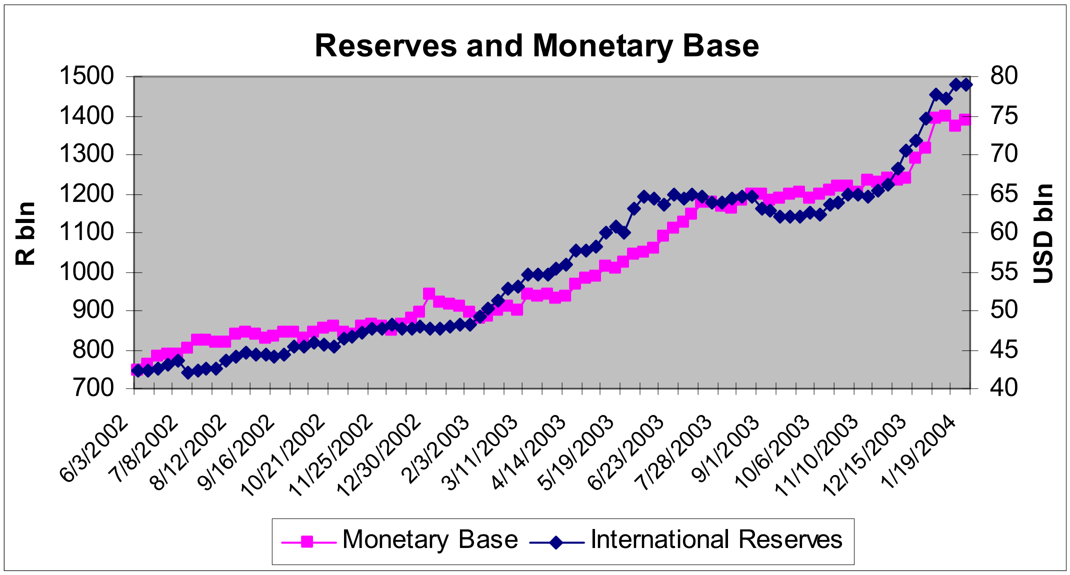




International Reserves and Monetary Base

The international reserves of the CBR and Finance Ministry increased again last week, reaching another record maximum of USD 79.1 billion as of January 16, which is 0.25% higher than the week before. The modest increase is explained by the fact that the CBR preferred not to intervene massively on the currency market during the week of Jan.12-16 to support the falling dollar. The CBR is currently limiting its participation on the currency market in an attempt to hold back January inflation, as this month an increase in the services tariffs (housing services) puts upward pressure on prices.

The monetary base resumed its growth at a modest pace of 0.98% for the week, to a total of RUB 1,385.3 billion as of January 19. The CBR also announced a significant 55% y-o-y (24.3% m-o-m) increase of the broad money base, which includes cash, bank obligatory reserves at the CBR, banks' correspondent accounts and deposits at the CBR in December. Most of the increase is attributed to the CBR flooding the market with rubles and buying dollars from the market. This might upset the plans of the government to hold annual inflation to 10%. The increased base money affects the inflation with an estimated time lag of 6-8 months.



Russia's 2004 Budget

The 2004 Budget Law (BL) was approved and published in December 2003. With total revenues of RUB 2,745 billion and total expenditures of RUB 2,659 billion, the 2004 BL notably shows a drop, as a percentage of GDP, of six tenths of one percent in both revenues and expenditures when compared to the 2003 BL. Debt service is only one tenth of a percentage of GDP lower. Some of the assumptions for the 2004 BL are considered below.

Macro Assumptions – The growth and revenue assumptions for the 2004 BL are considered to be low by many analysts. The average Urals Crude price used for the 2004 BL is USD 22.5. This is 5 % higher than the assumption in the 2003 BL, 20% lower than the actual average price in 2003, and lower than 2004 market forecasts of USD 27. The average RUB/USD rate of 31.5 for the 2004 BL already looks weak in comparison to the current rate of 28.5 and the average rate for 2003 of 30.68. The RUB is not free floating, but rather managed by the CBR (the massive amount of foreign reserves accumulated by the CBR, partially in its attempt to restrain the nominal appreciation of the RUB against the USD, is a sign of the CBR difficulty in managing the RUB rate when energy prices stay high). The real GDP growth reflected in the 2004 BL is 5.2%; this is higher than the 2003 BL number of 4.4%, but lower than the market forecast of 6.0%. Inflation is forecast to be 10% in the 2004 BL as opposed to the 2003 actual and BL level of 12%, and slightly lower than 2004 market forecasts of 10.5%. Inflation, and the fight against it, is a wild card that many see as a potential enemy to Russia's economic plans.

Revenue Changes – The 2004 BL shows a total change in revenues over the 2003 BL of RUB 325 billion (a 13% change). There are several tax code changes that take place in 2004. The sales tax is eliminated, but this will have no direct effect on federal revenues as the revenues were previously dedicated to sub sovereigns of the RF. The VAT drops from 20% to 18%. This tax in the past constituted 25-30% of total government revenues (6.8% of GDP in 2003); this should then mean a 2.5-3% drop in total revenues. The RF expectation is that the introduction of VAT accounts will increase compliance enough to make up what would otherwise be a shortfall, but the jury is still out on this issue. The MOF does not expect any difficulty in meeting revenue targets with these and other changes; offsetting taxes and, as with VAT, general compliance are supposed to make up the difference; a revenue surplus due to high energy prices is expected to provide a cushion.

Expenditures – There are no significant shifts in expenditures as a portion of the overall budget between the 2003 BL and the 2004 BL. The 2004 BL shows a total change in expenditures over the 2003 BL of RUB 313 billion (a 13% increase). There are small increases for defense, judiciary reform, and other areas such as R&D and cultural support. There is no substantial increase for renovation and upgrade of physical infrastructure.

Budget Surplus - The budget surplus expected in the 2004 BL is RUB 83 billion (0.5% GDP) as compared to the 2003 BL of RUB 72 billion (0.6% GDP). Significant is the fact that the actual surplus in 2003 was RUB 160 (1.2% GDP). The surplus for 2004 should go into the Stabilization Fund, taking some pressure off the CBR in its attempts to fight RUB/USD appreciation and not flood the market with RUB.

Financing – There is no net new financing planned for in 2004 BL. There is a move to refinance maturing external debt with domestic debt. The liability currency shift in 2004 is RUB 170 billion. The current mix of domestic to external liabilities is 15/85. The MOF wants this to be 25/75 by the end of 2006. The increase in domestic securities outstanding will give the CBR an enhanced tool to remove liquidity from the domestic financial system.

Fiscal Reserve (FR) & Stabilization Fund (SF) – What will happen to the accumulated and planned surpluses? The FR, which was a temporary creation for debt service in 2002 and 2003, is now to be divided between and transferred into a cash account at the CBR and the SF. At the end of 2003, the FR had RUB 255 billion at the CBR. RUB 103 billion is to be transferred to the SF. Approximately RUB 100 billion is to be kept in MOF cash balances at the CBR for perpetuity (the MOF is expected to keep 1/24 of annual budget expenditures as a cash balance cushion, increasing or decreasing the amount each year to reflect the current year's expenditures). The SF is capped by law at RUB 500 billion.

Conclusion – The Russian Federation exercised admirable fiscal restraint in 2003. This is in spite of the fact that there were Parliamentary elections. With President Putin now having the support of a constitutional majority in Parliament, and expected to be easily re-elected as President in March of 2004, one could expect another year of good fiscal restraint. This all, of course, assumes high oil prices.

Budget Detail[1]						
	2004 BL		2003 BL		2003 Actual	
	RUB (billion)	% GDP	RUB (billion)	% GDP	RUB (billion)	% GDP
Revenues (total)	2743	17.9	2418	18.5	2571	19.4
Revenues w/o Social Tax	2305	15.1	2052	15.7	2203	16.6
Social Tax	438	2.9	366	2.8	368	2.8
Expenditures (total)	2659	17.4	2346	18.0	2411	18.2
Debt Service	288	1.9	278	2.1	277	2.1
Non Debt Service Expenditures	2372	15.5	2068	15.8	2135	16.1
Non Debt Service Expenditures w/o social tax	1934	12.6	1702	13.0	1761	13.3
Social tax transfers	438	2.9	366	2.8	373	2.8
Total Surplus	83	0.5	72	0.6	160	1.2
Primary Surplus	371	2.4	350	2.7	437	3.3

Macro Economic Parameters				
	2004 BL[2]	2003 BL[3]	2003 Actual[4]	2004 Forecast[5]
Nominal GDP (RUB billion)	15, 300	13,050	13,255	15,707
GDP Growth Rate	5.2%	4.4%	7.0%	6.0%
Average RUB/USD	31.3	34.0	30.7	28.3
Inflation (Annual)	10.0%	12.0%	12.0%	10.5%
Oil Price Urals (USD/ bbl)	22.5	21.5	27.1	27.0

[1] Source MOF & IMF
[2] Source Economic Expert Group
[3] Source Economic Expert Group
[4] Source Economic Expert Group
[5] Source Troika Dialog

EXPLANATORY NOTES

1. **EXCHANGE RATES**: SELT - "System of Electronic Lot (currency) trading" -- a computer based OTC-style trading system organized by the Moscow Interbank Currency Exchange (MICEX). MICEX Unified Trading Session (UTS) is the one in which exporters have to sell repatriated currency. Minimum lot size for each of the dollar instruments is USD100,000. Average price is quoted as the weighted average of all actual deals entered into the system by various banks.

2. INTEREST RATES: Moscow InterBank Actual Credit Rate is calculated as the average-weighted rate on the volume of actual transactions in interbank loans by commercial banks.

3. STOCK INDICES: The RTS index is the only official indicator of the Russian Trading System. It is calculated every 30 minutes of the RTS trade session, starting at 12:00. It comprises 60 shares of 35 leading companies. These shares are included in so-called Category "A" listings. The index indicates over-the-counter stock prices. The index represents the ratio of the total market capitalization of the shares of the companies selected for the index to the total market capitalization of the same shares as of the initial date multiplied by the index value as of the initial date (31 December 1997) using a base of 100 beginning September 1, 1995. The ruble-adjusted index is a derivative of the main dollar index, using the same base. The MICEX index is calculated by the stock section of the Moscow Interbank Currency Exchange and is based on the price fluctuations of 17 shares of the MICEX's first and second listings.

4. INTERNATIONAL RESERVES OF THE RUSSIAN FEDERATION represent the amount of reserve assets of the Bank of Russia and Finance Ministry. Those reserve assets are comprised of monetary gold, special drawing rights, the reserve position in the IMF and other liquid foreign assets. The latter include short-term deposits in non-resident and resident banks, balances in current accounts, foreign government securities, repo agreements with these securities made with non-residents, and other liquid assets (accrued interest on these assets is not included). Monetary gold is evaluated at a floating rate, revised periodically, but not always reported immediately. Foreign currency assets are converted into U.S. dollars on the basis of the cross rates of foreign currencies to the dollar, calculated using the official rates of the ruble to these foreign currencies, as set by the CBR.

5. MONETARY BASE (M1) is comprised of cash and reserves of commercial banks on deposit in the CBR. It is the basic part of the money supply (M2).

6. LOMBARD CREDITS, distributed through auctions, are aimed to provide liquidity to the banking sector. These credits are extended to banks on the basis of collateral.

7. JPMORGAN EMERGING MARKETS BOND INDEX PLUS (EMBI+) tracks total returns for traded external debt instruments in the emerging markets. The instruments include external-currency-denominated Brady bonds, loans and Eurobonds, as well as U.S. dollar local markets instruments. The EMBI+ may be separated into individual components (such as by sovereign issuer). The source of all EMBI+ data in this publication is JPMorgan.

8. CBR TIME DEPOSIT RATE is set by periodic auctions held by the CBR that allow banks to hold money there at fixed terms for interest. The interest rate is set by the auction process, but the CBR sets the terms, which range from one week to several months and are not always the same at each auction. The benchmark time-deposit rate we will try to use is the shortest one. These auctions are not necessarily held on a regular weekly basis, so some data related to this indicator may not always appear in the Financial Weekly.